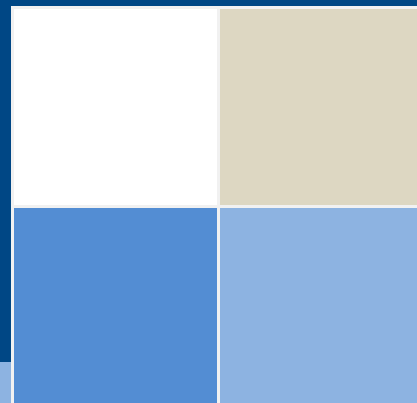


Policy Analysis - No. 04/2015



GROUP FOR LEGAL  
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STUDIES

# An Assessment of the new VAT Policy in Kosovo: its potential impact on consumers and businesses



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July 2015

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Inputs/information and data contained in this analysis are collected as part of the project 'For a transparent law-making process in Kosovo'.



An EU funded project managed by European Union Office in Kosovo.

Implemented by GLPS and GAP



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# AN ASSESSMENT OF THE NEW VAT POLICY IN KOSOVO: ITS POTENTIAL IMPACT ON CONSUMERS AND BUSINESSES

## I. Introduction

Like most of the Balkan countries, the Republic of Kosovo has been, and still is, undergoing socio-economic and political transformations. Having the lowest GDP per capita in Europe, Kosovo's main challenge remains a dynamic and sustainable economic development perspective. Kosovo's economy is characterized by very large fiscal evasion and underreporting of sales and wages, which altogether are factors determining the size of informal economy in Kosovo. However, given that Kosovo has no monetary policy; fiscal policy remains the only economic instrument used by policymakers to influence Government revenues and impact the dynamics of economic development.

Similar to the vast majority of countries worldwide, Kosovo also applies the value added tax (VAT) which presents an indirect tax on the consumption of goods and services. VAT is charged at a fixed rate of 16%, in accordance with the Law on Value Added Tax (hereinafter the 'Law on VAT').<sup>1</sup> The Law has undergone several amendments,<sup>2</sup> but the rate remained unchanged until in the beginning of 2015, when the new governmental coalition came into power. The Minister of Finance (hereinafter the 'Minister'), Mr. Abdullah Hoti, has noted that the Law on VAT is not being amended, but is being entirely rewritten.<sup>3</sup> This is the first time after the independence of Kosovo that the VAT system is being reshaped entirely.

In the first and second part, this paper, in general, identifies the impact that changes in the Draft Law on Value Added Tax (hereinafter the 'Draft Law' or 'Draft Law on VAT')<sup>4</sup> will have in Kosovo. To that aim, the paper initially assesses the international experience and evidence with regard to distributional effects from the introduction of the differentiated VAT system and tries to place it within the context of Kosovo. Of course, in this part of the paper, remarks about administrative capacities of Kosovo institutions to handle these changes and explanations how the current VAT system worked have received a special attention. For methodological purposes, we have only selected the introduction of the differentiated VAT system and the reduction of the VAT threshold for further analysis due to their potential

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<sup>1</sup> See Law No. 04/L-108 On Amending And Supplementing The Law No. 03/L-146 On Value Added Tax as Amended And Supplemented By The Law No.03//L-197. May 2012. Available at <http://www.kuvendikosoves.org/common/docs/ligjet/Law%20on%20amend%20the%20law%20on%20value%20added%20tax.pdf>

<sup>2</sup> The first Law to regulate the Value Added Tax was Law No. 03/L-114 adopted in December 2008, and entered into force in January 2009; Available at [http://www.kuvendikosoves.org/common/docs/ligjet/2008\\_03-L-114\\_en.pdf](http://www.kuvendikosoves.org/common/docs/ligjet/2008_03-L-114_en.pdf)

The second amendment to the VAT Law was approved by the Assembly of the Republic of Kosovo in December 2009, and entered into force in January 2010; Available at <http://www.kuvendikosoves.org/common/docs/ligjet/2009-146-eng.pdf>

The third amendment to the VAT Law was approved in May 2012 and is still in force. Available at <http://www.kuvendikosoves.org/common/docs/ligjet/Law%20on%20amend%20the%20law%20on%20value%20added%20tax.pdf>

<sup>3</sup> Meeting of the Commission on Finance and Budget. 20 May 2015. Minister of Finance, Mr. Abdullah Hoti, and Central Bank Governor, Mr. Bedri Hamza, were invited to report to the Commission.

<sup>4</sup> Draft Law on Value Added Tax. March 2015. Division of Fiscal Policy – Ministry of Finance.

influence in the socio-economic situation in the country. The Government is willing to introduce a differentiated VAT system (reduced rate) and reduction of the VAT threshold (VAT taxable turnover) for businesses from € 50,000 to €30,000 of the businesses annual turnover. The paper likewise will analyze the potential impact of these changes on consumers and businesses given that the latter were justified on grounds of sharing the burden of taxation in a more equal manner, i.e. to increase the welfare of households with lower income.<sup>5</sup> In this part, however the analysis of the budgetary implications will not be core component of the study, since, so far, additional changes that are likely to impact budget revenues, i.e. VAT exemption on imports, and other special exemptions in respect of imports, are alien and still need to be defined by the Ministry through other acts.<sup>6</sup> The third part analyzes implications of the reduction in VAT threshold, and the fourth analyzes several risk scenarios related to the substantial pass on to consumer prices from VAT changes. The last section of the paper provides an overall assessment and recommendations based on the research findings.

## II. The Distributional Effect of VAT: International Experience Evidence

In Kosovo, as in the tax policy debate, the reasoning for introducing the differentiated VAT system is improving the income distribution. However, since there are other policy distributional mechanisms, for example, income taxation, this paper is willing, from an applied policy perspective, to determine whether a differentiated VAT system in Kosovo would produce better results in terms of income distribution associated with lower compliance costs. Due to lack of data this policy analysis will not be able to measure the distributional effect empirically. In the meantime, the distributional effect cannot be measured solely by theoretical considerations; therefore, this section discusses the international experience and evidence that empirically measured VAT impact in better income distribution.

To begin with, reduced VAT rates have been traditionally supported and justified by the idea that poor households spend a large share of their income on basic consumption products.<sup>7</sup> This holds true also in Kosovo. According to the latest results of the Kosovo Statistical Office about 44% of households' budget is spent on consumption, 28% on housing, and other smaller percentages are spent on clothing, health, education, and alcohol.<sup>8</sup> In general, although poor households seem to spend a greater share of their income on consumption than households with higher income, in absolute terms the latter spend much more on consumption compared to the former. Thus, the first effect that we can identify is that the reduced VAT rate would potentially benefit high-income households more, taking into consideration the fact that, in absolute terms, they spend much more on consumption. There is a high likelihood that the same situation would apply to Kosovo as well with the introduction of the differentiated VAT system (standard rate and reduced rate). Second, a reduced VAT rate has not proven to be the best instrument for income distribution. Boeters et al. investigated empirically the effect of VAT change in the German

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<sup>5</sup> Meeting of the Commission on Finance and Budget. op.cit. note 4.

<sup>6</sup> See Draft Law on Value Added Tax. Chapter IX. March 2015. Ministry of Finance, Republic of Kosovo.

<sup>7</sup> Charlet, A and Owens, J (2010) "An International Perspective on VAT" Publishing on Tax Notes International.

<sup>8</sup> Kosovo Agency of Statistics (2014) "Rezultatet e Anketes se Buxhetit te Ekonomive Familjare" Office of the Prime Minister, Republic of Kosovo. Available at file:/Rezultatet%20e%20Anketes%20se%20Buxhetit%20te%20%20Ekonomive%20Familjare%202014.pdf

economy by employing the 'Applied General Equilibrium' approach. The study suggests that VAT differentiation can hardly be considered as an effective means of redistribution policy.<sup>9</sup> According to the same author, the introduction of a harmonized VAT, combined with marginal income tax rate reductions or social security constitutions, would produce better results in supporting the entire population, not only poor households.

Third, most of the EU countries employ a differentiated VAT system with two or three different VAT norms, apart from Denmark (and Bosnia and Herzegovina that is not member of the EU).<sup>10</sup> Other countries, for example Switzerland which raised the issue in a public discussion for the first time in 2007, and the Czech Republic, have announced that they are planning to change their VAT systems to a fix VAT rate. Other European countries have broadened their VAT base by applying their standard rates to other sectors and categories. For instance, Spain has a standard rate of 21% and has extended the application of the rate to other categories and services, such as artistic performance, cinemas, and theatres that previously were taxed under the reduced rate.<sup>11</sup> Overall, according to Copenhagen Economics Study, EU member states face large fiscal and economic losses due to their differentiated VAT system.<sup>12</sup> Thus, according to the same source, a single VAT rate, from an economic perspective (like compliance cost and market deviations), is seen as the best tax policy option. Other studies, however, indicate the advantages in terms of efficiency and administration of having a standard versus a differentiated VAT system and the very low distributional effect of the reduced VAT rate compared to other mechanisms.<sup>13</sup>

Fourth, a single standard VAT rate has clearly been supported since 1980s.<sup>14</sup> This view was also supported by well-known empirical comprehensive studies of Copenhagen Economics<sup>15</sup> and Mirrlees Review of UK taxes,<sup>16</sup> which show that a standard VAT rate would allow significant revenues to be used while lowering compliance costs for businesses and tax authorities. In general, economists from the IMF in a study show that multiple rates distort consumer and producer choices, and provide favorable treatment of certain goods, thereby making room for constant complaints on the part of a business community producing or selling substitutes.<sup>17</sup> Other empirical studies such as IMF (2010), IFS (2011),

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9 Boeters, Stefan; Böhringer, Christoph; Büttner, Thiess; Kraus, Margit (2006) "Economic Effects of VAT Reform in Germany", ZEW Discussion Papers, No. 06-30.

10 Topic-Pavkovic, B. (2015). "Characteristics of the Value Added Tax in Bosnia and Herzegovina" Mediterranean Journal of Social Sciences. MCSER Publishing, Rome-Italy. Vol. 6 No 2 S2.

11 European Commission (2013). "Tax reforms in EU Member States 2013. Tax Policy challenges for economic growth and fiscal sustainability." European Economy 5|2013. Available at [http://ec.europa.eu/economy\\_finance/publications/european\\_economy/2013/pdf/ee5\\_en.pdf](http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee5_en.pdf)

12 Copenhagen Economics (2007) "Study on reduced VAT applied to goods and services in the Member States in the European Union."

13 Ibid.

European Commission (2010) "On the future of VAT, towards a simple, more robust and efficient future of VAT."

Charlet, A and Owens, J op. cit. note 8

Boeters, Stefan et al. op. cit. note 10

14 See, e.g., Robert P. Hagemann, Brian R. Jones, and Robert Bruce Montador, "Tax Reform in OECD Countries: Economic Rationale and Consequences," OECD Economics Department Working Paper No.40, Aug. 1987, OECD Publishing, pp. 34-37. Cited in Charlet, A and Owens, J (2010) "An International Perspective on VAT" Publishing on Tax Notes Publishing

15 Copenhagen Economics op. cit. note 13

16 Mirrlees, J. 2010 "Dimensions of Tax Design". The Mirrlees Review. Edited by the Institute for Fiscal Studies. Oxford University.

17 Tait, A., A., (1988), Value Added Tax. [Online] Available at <http://www.imf.org/external/pubs/cat/longres.cfm?sk=127.0>{As cited in Antic, D. (2014). "Efficiency of a single-rate and broad-based VAT system: the case of Bosnia and Herzegovina"}

indicate that a differentiated VAT system, in both developed and developing countries is an inefficient means of income redistribution.<sup>18</sup> Furthermore, the IMF country report for Kosovo has acknowledged that broadening the tax base is desirable, as taxes are relatively low compared to the region; however, it does not recommend the introduction of the differentiated VAT system.<sup>19</sup> In the below section we draw upon VAT significance as an instrument of fiscal policy in Kosovo.

### III. VAT as an Instrument of Fiscal Policy in Kosovo

As briefly mentioned in the introduction, the Law on VAT was adopted in 2008, and has continually been the subject of several amendments until the latest changes in the first part of 2015. VAT is one of the most efficient tools of the government for revenue collection given that it constitutes for more than 45% of tax revenues.<sup>20</sup> The table below shows in numbers the VAT collection in the last three years, as compared to the total tax revenue collection. The data in the table indicates the significant effect on the budget since it generates almost as much as the amount generated by all other tax revenue sources.

	2012	2013	2014	
<b>VAT</b>	€ 131.394.869	€ 149.184.989	€ 136.939.023	45%
<b>Total Tax Revenue</b>	283.9 approx.	305.4 approx.	303.7 approx.	(in mil.)

Table1: Total Tax Revenue

Source: Tax Administration in Kosovo, Annual Report 2014.

The current major changes in the Draft Law on VAT, which have been widely debated in the general public, include the introduction of the differentiated VAT system and the decrease in the VAT registration threshold for businesses. First, the new VAT system introduces a reduced rate of 8% for all basic consumption products including bread, rice, oil, milk and public utilities, including electricity services, central heating, and waste collection. This represents a 50% decrease from the initial standard rate of 16%. Considering the importance of VAT on budget revenues, in order to make up for the lost revenues with the introduction of the reduced rate, the Draft Law on VAT foresees an increase of the standard rate from 16 to 18% for all other remaining categories. In the meantime the rate of 0% is applied to exports with the aim of stimulating export-oriented companies. Second, the Draft Law introduces the reduction in the VAT threshold for businesses from €50,000 to €30,000. It is important to note that the changes in VAT are in line with the EU Directive on VAT which

<sup>18</sup>IMF, 2010. From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies. Washington: International Monetary Fund.

<sup>19</sup>IFS, 2011. A retrospective evaluation of elements of the EU VAT system. Final report. TAXUD/2010/DE/328. London: Institute for Fiscal Studies. { As cited in Antic, D. (2014). "Efficiency of a single-rate and broad-based VAT system: the case of Bosnia and Herzegovina" }

<sup>19</sup>IMF (2013). Country Report, Republic of Kosovo. 2013 Article IV Consultation.

<sup>20</sup> Tax Administration in Kosovo. (2014). Annual Report. Available at <http://www.atk-ks.org/wp-content/uploads/2010/09/Raporti-i-punes-per-vitin-2014.pdf>



does not allow states to introduce VAT rates below 5% and above 22%.<sup>21</sup>

### A) Institutional Administrative Capacity and Compliance Cost

Introduction of the reduced VAT system involves high compliance costs, particularly when introduced in the food sector. The Copenhagen Economics study draws on examples of the Swedish, Ireland, and UK reduced VAT systems, which evidenced substantial compliance costs.<sup>22</sup> The same study indicates that in Ireland the differentiation of healthy and unhealthy food lead to 89 categorizations of food, including the difference between roasted and non-roasted almonds. In Kosovo, in accordance with the VAT Law, the Tax Administration in Kosovo (henceforth TAK) has the exclusive responsibility to administer the VAT.<sup>23</sup> To date, the TAK has not undergone any major administrative changes, thus has not incurred any costs related to the Draft Law on VAT. In addition, in order to implement the Draft Law when it enters into force, the TAK has its own resources in terms of knowledge and staff capacity; therefore, according to TAK officials, TAK does not plan to incur any additional cost.<sup>24</sup> The only supposed change will be an increase in the number of taxpayers, due to the decreased VAT threshold for businesses; however, it does not represent any additional burden to the TAK. According to data from the TAK, approximately 2,000 businesses will enter VAT registration, but there is no classification based on production or service activities of these companies.<sup>25</sup> Alongside the TAK, the Kosovo Customs (KC) is responsible to collect revenues at the border and should adapt technological changes to implement the new VAT Law. Officials at Kosovo Customs state that these technological changes at Kosovo Customs do not involve any cost, and that it might take two to three weeks before they are finalized, due to testing procedures in the program.<sup>26</sup> Nevertheless, these statements are in contrast with major literature findings, which indicate that the introduction of a reduced VAT rate involves high administrative and compliance costs for respective country budgets, particularly for the food sector (as is the case in Kosovo). The following section will draw upon the implications of the VAT threshold decrease in businesses life cycle.

## IV. Implications of the VAT Threshold Decrease

Another major change introduced in the Draft Law on VAT is the reduction of the VAT registration threshold for businesses from €50,000 to €30,000 of their annual turnover, which, if fully implemented, is considered to increase budget revenues. The VAT registration of €50,000 is the highest in the region, and the IMF country report for Kosovo suggested that any reduction in the threshold should be made only once the TAK has the needed capacity to handle the situation so as to avoid any unnecessary burden without clear gains in revenue collection.<sup>27</sup> According to TAK officials, there are approximately 2,000 businesses

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<sup>21</sup> COUNCIL DIRECTIVE 2006/112/EC .on the common system of value added tax. Official Journal of the European Union. Available at <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32006L0112&from=en>

<sup>22</sup> Copenhagen Economics op. cit. note 13

<sup>23</sup> See Draft Law on Value Added Tax. March 2015. Ministry of Finance. Republic of Kosovo.

<sup>24</sup> Interview with IsenLipovica and Sami Salihu. Tax Administration in Kosovo. June 2015.

<sup>25</sup> Ibid.

<sup>26</sup> Interview with Adriatik Stavileci. Spokesman of the Kosovo Customs. June 2015.

<sup>27</sup> IMF Country Report op. cit. note 20

that will automatically enter VAT registration with the new threshold.<sup>28</sup> However, a major problem relates to the absence of a system which categorizes businesses based on their economic activity, and lack of this data limits a more thorough analysis on assessing the impact of the reduced VAT threshold on businesses activity. But, a general analytical picture is evident -VAT registration is followed with other TAK requirements, which will potentially be translated into higher finance and administration costs for businesses. In general, given the poor performance of businesses, higher financial obligations will consequently impact their level of profit. Particularly, the reduction of the VAT threshold will impact businesses that have just passed the threshold of €30,000. Furthermore, businesses will also need to adapt their technological systems in accordance with VAT changes; however, according to officials of the TAK, there will be no major cost that would potentially present a financial burden to businesses.<sup>29</sup> The following section will provide four risk scenarios related to the impact of VAT escalation on consumers.

## V. Risk Scenarios: Impact on Consumers

The current Draft Law on VAT consists of VAT escalation which is justified in grounds of having a more distributional tax burden, and thus an increase in the social welfare of poor households<sup>30</sup> who spend around 45% of their budget on consumption.<sup>31</sup> From a theoretical perspective, changes in VAT should affect consumer prices, although that depends on several criteria as explained in the following risk scenarios. In our context, VAT changes should have a positive impact on consumer prices and should mean a decrease in prices of basic consumption products and public utilities like electricity, central heating, and waste collection. However, considering the theoretical basis for the elasticity of products and the sellers rational behavior (utility maximization), as well as the lack of cents in circulation and the ex-ante rationality of businesses, there is a high likelihood that VAT changes will not be passed on to consumers who were the targeted beneficiaries to the above proposed changes. The following sections will present four risk scenarios, from a theoretical perspective in the context of Kosovo, related to the substantial pass through VAT rates to consumer price.

### A. Risk Scenario I

The reduced VAT rate of 8% on consumption products and public utilities is supposed to benefit final consumers, as VAT in principle is paid by these consumers. First, the basic consumption products in economic theory, such as oil, sugar, bread, milk, and cereal, present products that have very low demand elasticity (price in-elastic). In practice, low demand elasticity means that any small price difference will not affect consumer behavior. Given that theoretical argument, businesses will most probably not be incentivized to lower prices in accordance with the reduced rate because the demand for these products is inelastic. In addition, as there is no substitute for oil, bread, and milk, demand will not be

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<sup>28</sup> Interview op. cit. note 25

<sup>29</sup> Tax Administration in Kosovo. (2015). The interviewer wishes to remain anonymous.

<sup>30</sup> Meeting of the Commission on Finance and Budget op.cit. note 4.

Interview op. cit. note 30

<sup>31</sup> Kosovo Agency of Statistics.(2014) "Rezultatet e Anketes se Buxhetit Ekonomice Familjare 2013". Prime Minister Office, Republic of Kosovo.

affected even if there is no decrease in prices for these products. At the same time, we operate in a free market economy; thus, the government or any other institution is not allowed to intervene and reflect VAT changes in price changes. Overall, considering the above-mentioned theoretical argument and the rational behavior of sellers/businesses as utility maximizers, there is a very low likelihood that businesses will react to these changes accordingly. Nevertheless, it is important to also take into consideration the competition of the retail chain, which has the potential in the meantime to foster the reflection of at least partially pass through to consumer prices. However, considering the third risk scenario (presented below) there is very low likelihood that these prices will be passed on. Second, according to the Draft Law<sup>32</sup>, services such as supply of electricity, central heating, and waste collection will also be taxed with the reduced VAT rate. In comparison to the basic consumption products lists, there is a very high likelihood that price decreases in the above mentioned services will be passed on to final consumers immediately (one month) after the Draft Law enters into force.

## B. Risk Scenario II

The new standard VAT rate increase from 16% to 18% is supposed to have an impact in the increase of prices. The 2 percentage points VAT increase represents a real increase of 12.5% in prices. To further illustrate, suppose a product costs €100, and with a VAT of 16% the price is €116, whereas when the VAT increases to 18% the price is €118. In terms of percentage, the price would be 12.5% more than with the initial VAT rate.

The Ministry of Finance will issue several normative acts with lists of products that will be taxed with the reduced VAT rate, procedures for tax reimbursement, and the like. Apart from that, the Ministry has not announced how they will approach the public to inform them about the list of products, as the majority of citizens do not know where to find or how to read normative acts. Given that, there will be asymmetry of information, which most probably will be beneficial to businesses only. In addition, in economic theory, the basic law on demand states that any increase in prices will lower the demand for a certain product, *ceteris paribus*, as a consequence consumers will switch to other products. This does not hold in this case because the price of almost all products that are not on the list of basic consumption products will increase and there are products that cannot be replaced. For instance, potatoes and sugar have not been included on the list of basic consumption products, but they cannot be replaced with other products. In general, the list of products and services to be taxed by 18% is much longer compared to the one to be taxed by the reduced rate of 8%. Therefore, businesses will not be threatened by the supposed 'price elasticity' theory in the present case, and there is a high likelihood that the cost of living in Kosovo will increase. Furthermore, the below tables show several products that will be taxed at 8% and at 18% based on the average price calculated in the 'Price Index' of the Kosovo Agency of Statistics.<sup>33</sup>

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<sup>32</sup>See Draft Law on Value Added Tax. (2015) Chap. VII Rates.Art.26 The rate. Ministry of Finance. Republic of Kosovo.

<sup>33</sup>Kosovo Agency of Statistics (2015). "Statistikat Ekonomike- Indeksi I Harmonizuar I Cmimeve te Konsumit (Maj-2015)" Office of the Prime Minister, Republic of Kosovo. Available at <https://ask.rks.gov.net/dmdocuments/Indeksi%20i%20Harmonizuar%20i%20Cmimeve%20te%20Konsumit%20Maj%20-%202015.pdf>

	Product	Quantity	Price with VAT (16%)	Price with VAT (8%)	The decrease in prices
1	Bread	500gr	€ 0.34	€ 0.32	€ 0.02
2	Rice	1kg	€ 1.29	€ 1.20	€ 0.09
3	Wheat Flour	1kg	€ 0.39	€ 0.36	€ 0.03
4	Eggs	30 pieces	€ 1.88	€ 1.75	€ 0.13

Table.2: Products under the VAT reduced rate of 8%  
Source: Kosovo Statistical Agency

	Product	Quantity	Price with VAT (16%)	Price with VAT (18)	The increase in prices
1	Potatoes	1kg	€ 0.45	€ 0.46	€ 0.01
2	Beans	1kg	€ 2.46	€ 2.50	€ 0.04
3	Sugar	1kg	€ 0.63	€ 0.64	€ 0.01
4	Tea	1kg	€ 5.40	€ 5.49	€ 0.09
5	Tomatoes	1kg	€ 1.01	€ 1.03	€ 0.02
6	Chicken Meat	1kg	€ 2.64	€ 2.69	€ 0.05
7	Veal	1kg	€ 7.29	€ 7.42	€ 0.13
8	Diesel	1kg	€ 1.08	€ 1.10	€ 0.02
9	Petrol/Gas	1kg	€ 1.09	€ 1.11	€ 0.02

Table 3: Products under the VAT standard rate of 18%  
Source: Kosovo Statistical Agency

The list of products that will be taxed with 8% leaves out other basic products such as potatoes, beans, sugar, meat, and tomatoes.<sup>34</sup> For instance, as shown in Table.3 the price of veal will increase by at least € 0.13 and the price of tea by € 0.09. This in turn will have an impact on the cost of living, particularly for medium income households, which spent most of their budget on these products. Overall, in contrast with the reduced VAT rate, the standard VAT rate of 18% will be passed on to the final consumer prices within a very short period of time after the Draft Law enters into force.

### C. Risk Scenario III

Many products on the Kosovo market are priced in cents similar to € 0.99, € 1.22, € 0.33 and the like; however, cents are rarely given back to consumers as change for two main reasons. First, there are very few consumers that would ask back for the cents, as it is culturally accepted that prices are rounded up. Second, there is lack of cents in circulation, thus prices are usually rounded up at the cash register. Given that, this ‘cent phenomenon’ will facilitate the increase in prices and will impede price decrease. In general, apart from a few opinions that have been written about the ‘cent phenomena’ and consequent businesses benefits, there is no campaign to change this cultural habit of not giving or asking for cents back.

<sup>34</sup> For more about the list of products and differences in prices, see GAP Institute (2015). “Efektet ekonomike dhe buxhetore te reformave fiskale.”

Taking into consideration the ‘cent phenomena’, below we have drawn a table which shows what would be the difference in price with the reduced VAT rate of 8% in few basic consumption products.

Nr.	Product	Quantity	Current Price (with VAT 16%)	Price without VAT	Price with VAT 8%	Difference in price
1.	Bread	500gr/ 1 bread	€ 0.34	€ 0.29	€ 0.32	€ 0.02
2.	Milk	1liter	€ 0.90	€ 0.78	€ 0.84	€ 0.06
3.	Salt	1kg	€ 0.40	€ 0.34	€ 0.37	€ 0.03
4.	Oil	1liter	€ 1.10	€ 0.95	€ 1.02	€ 0.08

Table 4: Prices of few basic products that will have a reduced VAT rate of 8%  
Source: Author’s compilation and Kosovo Statistical Agency

The second and third column in Table 4 shows the product and the quantity. The third and the fourth column show the current price with the standard VAT rate of 16% and without VAT rate, respectively. The fifth column calculates the price with the reduced VAT rate of 8%, while the last column shows the difference in price with the introduction of the differentiated VAT system. As the price of some articles differs due to goods’ varieties in the market, the table indicates an average price for each product. For instance, as shown in the table, the price of bread would decrease by 2 cents, and be priced at 32 cents. However, considering the lack of cents in circulation, the so called ‘cent phenomena’, there is a very low likelihood that bakeries will sell their bread at 32 cents and if they do, there is a very low likelihood that cents will be given back to customers. At the same time, it is of no consideration that businesses would round up the price of bread at 30 cents, since that would mean lowering their profits. Given these challenges, there is a high likelihood that even if VAT changes are partially translated into lower prices, VAT benefits will not be passed on to final consumers, particularly for prices similar to the above-mentioned products which would cost only a few cents less. This shows that a lack of cents in circulation will facilitate an increase of prices and will impede a decrease. However, if a household spends around 500 kilowatt-hours for electricity during one month, the household will save 2.5€. <sup>35</sup> Overall, there is a higher likelihood that final consumers will benefit from the reduced rate in public utilities (as shown with electricity), but a very low likelihood for basic consumption products.

## D. Risk Scenario IV

This section provides an assessment of a risk scenario based on ex-ante rationality (previous businesses behavior to price changes). There are several important cases which show businesses’ behavior toward price changes resulting in no benefits for the final consumer including the price of bread, the price of petrol/gasoline, and private university exempt from taxes. These cases have shown that the Kosovo market is reluctant to decrease prices, while it reacts quickly to increase prices. For instance, first, the price of bread was 30-35 cents; afterwards, the price of bread increased of about 10 cents. <sup>36</sup> Given the initial price of bread the increase by approximately 30% is considered to be significant.

<sup>35</sup> GAP Institute op. cit. note 35

<sup>36</sup> GazetaJeta ne Kosove (2012) “Dyshime per KurdiseEdhe per Buke” Available at <http://gazetajnk.com/?cid=1,1018,2895>

The justification of businesses for this price increase was that the price of flour (a basic ingredient of bread) increased, and consequently affected the final price of bread. In the meantime, when the price of flour decreased, the price of bread remained the same.<sup>37</sup> In this case, there is no legal mechanism that would oblige businesses to change their prices. But as bread is a basic consumption product the Kosovo Competition Authority (KCA) should have conducted investigations to find out whether there was any cartel agreement among businesses. Nevertheless, this institution and others responsible failed to perform their duties and businesses have continuously abused the situation by maintaining their prices at a high level.

Second, as of 2012 private universities, among other institutions, were exempt from taxes.<sup>38</sup> However, this has not been followed by a change in the university fees for students. The tax exemption was supposed to benefit the final consumers, in this case students, but the only beneficiaries were university owners. One would suppose that this might have been a cartel agreement among university owners, but until now no action was taken in this regard and the responsible institutions failed to investigate and penalize such acts.

Third, due to the global petrol/gasoline price increases, the price of petrol/gasoline increased in Kosovo as well. Kosovo businesses justify the increase by the fact that global price increases are reflected in the market price in Kosovo. In global terms, the petrol/gasoline price has continually decreased since 2014;<sup>39</sup> however, the petrol/gasoline price in Kosovo has not dropped proportionally to the global price. Some suggest that petroleum businesses have agreed on price levels, knowing that no authority, including the KCA, would investigate or react in any manner.<sup>40</sup> These cases are an evidence of the incapability of Kosovo authorities to investigate cartel agreement cases in order to fight unfair competition and an informal economy; even though, petroleum is the key to production and to the economy. Overall, irrespective of the conditions and means, businesses in Kosovo have shown to be reluctant to lower prices but very quick to raise price. In this context, businesses would continue to further increase their profits if the authorities are not competent enough to control them.

## VI. The Potential Impact on Savings

The above risk scenarios presented four situations that might follow after the Draft Law on VAT enters into force, and which showed a very low likelihood of consumer benefits. On the other hand, it is important to note that if VAT reduction is passed on, in full or partially, as a price decrease, then low income households would be able to spend more of their income

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<sup>37</sup> Bota News (2011) "Nuk lirohet buka ne Kosove" Available at <http://botasot.info/lajme/127105/hKBTfHx/Telegrafi> (2013) " Mielli lirohet, bukaj o" Available at <http://www.telegrafi.com/ekonomi/lajme-ekonomi/mielli-lirohet-bukajo.html>

<sup>38</sup> Republika e Kosoves, Zyra e Kryeministrit (2012) "Kryeministri Thaci: Nga neser fillon nje kapitull I ri historik I evropianizmit te Kosoves, fillon zyrtarisht dialogu per liberalizimin e vizave per shtetin e Kosoves, per qytetaret e saj" <http://www.kryeministri-ks.net/?page=1,9,2604>

<sup>39</sup> Forbes (2014). "Oil Price Forecast for 2013-2014: Falling Prices" Available at <http://www.forbes.com/sites/billconerly/2013/05/01/oil-price-forecast-for-2013-2014-falling-prices/>

<sup>40</sup> Gazeta Express (2015) "Lumir Abdixhiku: Një litër naftë duhet të kushtojë 85 cent – Qeveria të ndërhyjë" Available at <http://www.gazetaexpress.com/lajme/nje-liter-nafte-duhet-te-kushtojte-85-cent-qeveria-te-nderhyje-71451/?archive=1>

Bota Sot (2015) "Abdixhiku tregon pse në Kosovë paguhet nafta më së shtrenjtinë rajon" Available at <http://botasot.info/lajme/356259/abdixhiku-tregon-pse-ne-kosove-paguhet-nafta-me-se-shtrenjti-ne-rajon/>

on consumption. Savings would continue to be low as this group of households would not be able to save from the reduced taxation and to invest in the long term. Given that, the money would again enter in the economy, most probably in the form of higher spending in consumption.

## VII. Overall Assessment and Recommendations

Recently, fiscal reforms have introduced the differentiated VAT system comprising of an increase in the standard VAT rate of 16 to 18%, and a reduced rate of 8% for a list of basic consumption products and services such as bread, water, energy, heating and waste collection. Moreover, the VAT threshold for businesses was decreased from €50,000-€30,000 on grounds of helping businesses by boosting competition and fighting fiscal evasion in the long-term perspective. Apart from the number of businesses that would enter VAT registration, no categorization of businesses in terms of their production or service activities was made. In general, there are no clear outputs for the announced fiscal reforms outlined by the Ministry of Finance in the form of any economic analysis on how such changes would impact the overall economy, whether low-income households or businesses. This gives the impression that these changes are part of a populist agenda<sup>41</sup> or targeted for budgetary revenue increases rather than thoughtful changes for the benefit of the population at large.

The following shortly presents potential risk scenarios based on the findings of this research:

1. The reduced rate of 8% includes basic consumption products, which are price inelastic. Therefore, there is a high likelihood that businesses will continue to charge the same final price due to unchanged demand for these products. Given that, the difference in VAT will only benefit certain groups of businesses leaving out the targeted beneficiaries – low income households.
2. The increase of the standard VAT rate from 16 to 18% is a 2 percentage point increase that represents a real increase of 12.5%. Considering the fact that more products and services will be taxed at an increased VAT rate, than those taxed at the reduced rate, this will lead to an increased cost of living. It is important to note that the list of products taxed at the higher VAT rate also includes products, which cannot be substituted such as sugar, and potato.
3. As shown above, there is a lack of cents in circulation and people hesitate to ask for cents back, thus prices are usually rounded up at the cash register. Therefore, even if VAT is partially passed on to consumer prices, there is a very low likelihood that it will benefit final consumers, since the so called ‘cent phenomena’ will potentially impede price decreases and facilitate price increases.
4. Previous businesses’ behavior shows that businesses in Kosovo are reluctant to lower prices and very quick to increase prices. At the same time, competent authorities like the Kosovo Competition Authority have failed to protect consumers and create a competitive environment. Therefore, there is a high likelihood that businesses will continue to react in the same way, as long as competent authorities

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<sup>41</sup> For more see the concept of populism.

fail to control them.

5. Approximately 2,000 businesses will enter VAT registration with the reduction of the VAT threshold for businesses from €50,000 to €30,000. However, there is no categorization of businesses based on their economic activities, which presents a limitation to a more thorough analysis. Nevertheless, it is evident that VAT registration might present a financial burden to businesses in terms of employing a finance officer to deal with TAK requirements and also in terms of higher financial obligations which consequently impacts their level of profit. This is particularly true for businesses that have just passed the threshold of €30,000.
6. If VAT reduction is passed on in full or partially as price decrease (for which there is a very low likelihood), then low-income households would be able to spend more of their income on consumption. In other words, the savings would be low and this group of households would not be able to save and invest in the long term. However, the money would again enter the economy, most probably in the category of consumption.
7. As VAT changes were justified on grounds of income distribution, it was important to find out what could be the potential impact of this. However, the distributional effect could not be assessed on theoretical grounds, and there is a lack of data to empirically assess the impact. Thus, looking at the international evidence experience, which indicates that the reduced rate on its own is not an efficient mean of income distribution, the same expectations apply to Kosovo, as well.
8. The Kosovo Statistical Office indicated that about 44% of households' budget is spent on consumption. In general, although low-income households seem to spend a greater share of their income on consumption than high-income households, in absolute terms the latter spend much more on consumption compared to the former. Thus, the reduced tax rate would potentially benefit high-income households to a greater extent than it does low-income households.

Therefore the following policies are recommended:

1. To date, competent authorities, including the Kosovo Competition Authority, has shown no results in fighting unfair competition and protecting consumers. Therefore, the capacity of the institutions in terms of human resources and financial means should be reconsidered. Strategic objectives and regulations within the respective institutions should also be revised.
2. The Ministry of Finance should carry out a quantitative assessment in order to measure the economic impact of the proposed changes in the Draft Law on VAT. Particularly the distributional effect should be assessed; since, as other international experiences show, there can be other mechanisms which would provide better results toward income distribution with lower costs.
3. Before the Draft Law on VAT enters into force, all necessary sub-legal acts should be consulted and ready by the Ministry of Finance. Otherwise, the implementation of the Law will be delayed, and as a consequence Kosovo Customs would have to retroactively deal with previous inflows and outflows.
4. As the Draft Law on VAT includes many legal acts which shall be issued by the Minister of Finance, it should be taken into consideration that rarely do citizens



know where to find and how to read and translate in practice sub-legal acts. Given that, the Ministry in cooperation with other institutions, should prepare information campaigns to inform citizens about the list of products to be taxed at the reduced VAT rate. Otherwise there will be asymmetry of information, which would be beneficial only to a smaller group of citizens.

5. After the Draft Law, which foresees businesses VAT reduction threshold, enters into force it will most likely present a burden to the businesses' life cycle. Data limitations in regard to business categorization about their activities limits this assessment; but, given the poor performance of businesses, it is evaluated that this change presents a financial burden which in turn can also have a negative impact on their level of profits. This is particularly true for businesses that have just passed the €30,000 threshold. Therefore, the Ministry of Finance in cooperation with the TAK should provide technical assistance in terms of trainings or free services for a certain period until businesses are able to financially sustain the changes.

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### **Policy Analysis**

Policy Analysis in general is a policy advice paper which particularly aims to influence the key means through which policy decisions are made in both local and central levels of government. The purpose of Policy Analysis is to address, more in-depth, a particular problem, to examine the arguments related to a concerned policy, and to analyze the implementation of the policy. Through Policy Analysis, Group for Legal and Political studies seeks to stimulate wider comprehensive debate on the given issue via presenting informed policy-relevant choices and recommendations to the key stakeholders and parties of interest.